EU Market Abuse Regulation 2016 – Implications for EU and Non-EU Investment Managers

Introduction

On July 3, 2016, the new EU Market Abuse Regulation (MAR)\(^1\) will apply and replace the existing EU Market Abuse Directive (MAD)\(^2\) and the existing national laws implementing MAD in each EU Member State.\(^3\)

This Sidley Update examines the implications of MAR, in particular the differences between MAR and MAD, for investment managers and other buy-side firms who deal in financial instruments within the scope of MAR.\(^4\) Although many of the concepts relating to market abuse that were implemented as part of MAD will continue under MAR, there are some important changes as discussed below.

It is important to note that certain aspects of MAR are extraterritorial in nature; thus, non-EU investment managers need to have an understanding of the MAR framework.

Expanded Scope of Financial Instruments Covered

MAD covers financial instruments admitted to trading on EU “regulated markets,” such as the main market of the London Stock Exchange.\(^5\) MAR, however, expands the scope of coverage so as to include financial instruments traded on multilateral trading facilities (MTFs) and organised trading facilities (OTFs). OTFs are a new type of trading venue created pursuant to MiFID II,\(^6\) for the trading of non-equity instruments such as bonds and derivatives; MiFID II is scheduled to be implemented by January 3, 2018.

\(^{1}\) Regulation (EU) No 596/2014. At the same time, a new EU Directive on Criminal Sanctions for Market Abuse (Directive 2014/57/EU) (CSMAD) is required to be transposed into the national laws of each EU Member State. The UK did not opt-in to CSMAD and, therefore, does not have to transpose it into national law; in the UK, existing UK criminal sanctions for market abuse will continue to apply.

\(^{2}\) Directive 2003/6/EC.

\(^{3}\) In the UK, for example, Section 118 of the Financial Services and Markets Act 2000, which contains the existing laws on market abuse in the UK, will be repealed. Further, existing rules contained in the UK Financial Conduct Authority’s (FCA) Code of Market Conduct are to be replaced with “signposts” to the relevant provisions of MAR, although the FCA will still be providing guidance to the various market abuse concepts in its Code of Market Conduct.

\(^{4}\) Accordingly, this Update does not address the provisions of MAR that are more relevant for issuers and sell-side firms, including new provisions on delayed disclosure of inside information, changes to the regime for persons discharging managerial responsibilities, share buy-backs, stabilisation, requirements for brokers seeking to rely on the safe harbour for market soundings, etc.

\(^{5}\) The scope of coverage was in fact expanded in the UK to include non-regulated markets such as AIM (a multilateral trading facility).

\(^{6}\) That is, the Markets in Financial Instruments Directive (Directive 2014/65/EU) and the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014).
MAR also expands the scope of coverage to include related spot commodity contracts (in addition to related derivatives under MAD) and emissions allowances. Furthermore, behaviour in relation to benchmarks is caught by the market manipulation prohibition under MAR.7

**Implications and Action Points to Consider**

- The expansion of scope of financial instruments covered under the new MAR regime to include all instruments traded on regulated markets, MTFs and OTFs means that there will be a significantly greater number of instruments caught under MAR as compared with MAD.

- For example, investment bank broker crossing networks (BCNs) on which securities are traded are expected, under MiFID II, to become MTFs or OTFs. At the same time, MiFID II will require that certain derivatives be traded on trading venues rather than on an OTC basis. All of this could result in a significant increase in the numbers of trading venues and financial instruments in scope of MAR.

- Although the existing MAD regime has always been extraterritorial in nature, the expansion of financial instruments in scope under MAR will make it easier for market participants to be caught within the EU market abuse framework without necessarily realising it. What might appear at first glance to be a purely non-EU transaction in relation to financial instruments issued by a non-EU issuer might well be subject to MAR on the basis that the non-EU issuer’s financial instruments are also capable of being traded on an EU trading venue. It would not matter if very little trading actually takes place on the EU trading venue. In this regard, MAR differs from the EU Short Selling Regulation, which exempts from its scope the shares of issuers whose “principal trading venue” is outside the EU.

- The following could be the result:
  - U.S. Fund Manager A trades with U.S. Counterparty B in the shares of U.S. Issuer C.
  - Issuer C’s shares are listed on the New York Stock Exchange (NYSE).
  - The trade takes place on the NYSE.
  - The “Investor Relations” page on Issuer C’s website refers solely to the NYSE listing.
  - However, Issuer C’s shares are also admitted to trading on an MTF in Germany.
  - Fund Manager A and Counterparty B will be subject to the EU standards relating to market abuse under MAR, since Issuer C’s shares also happen to be traded on a German MTF, even if the trading between the two U.S. entities occurs solely on the NYSE.

- Accordingly, market participants will need to monitor the instruments they trade, in order to understand whether they are subject to MAR. That means that non-EU investment managers will need to be familiar with the EU market abuse standards under MAR where there is an EU nexus. For example, the U.S. standard for insider dealing, particularly after the Second Circuit’s decision in *United States v. Newman*, differs quite markedly from the EU standard under MAR. For a general discussion of the differences between EU and U.S. standards for insider dealing, see the [Sidley Update](https://www.sidley.com), *The Einhorn/Greenlight Insider Dealing Case – EU/US Differences Highlighted, February 17, 2012.*

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7 A separate EU Benchmark Regulation has been adopted and will be published in the Official Journal shortly; the MAR benchmark provisions will be complementary to the regime under the Benchmark Regulation.
• As a practical matter, investment managers likely operate on the basis that if there is any hint of material nonpublic information regarding a particular issuer, that issuer would immediately be placed on the investment manager’s restricted list. That means, in many day-to-day situations, the distinctions between the U.S. and EU insider trading standards may not matter from a practical compliance perspective. However, non-EU managers may nonetheless on occasion be placed in situations where a difficult call needs to be made on a transaction. At those times, the distinction may well become material.

• Article 4 of MAR requires that the European Securities and Markets Authority (ESMA) publish a consolidated list of financial instruments that are admitted to trading or are otherwise traded on all EU trading venues (having received the relevant list of instruments from each Member State regulator, which in turn received the relevant list from each trading venue under its supervision). That should mean that a market participant can check ESMA’s consolidated list and find out if an instrument/issuer is within the scope of MAR.

• However, there are two issues with ESMA’s consolidated list:
  o Certain provisions of Article 4 of MAR have been postponed until the implementation date of MiFID II, including the requirement for ESMA to publish a list of financial instruments for the purposes of MAR. As noted above, MiFID II will not be implemented until January 3, 2018 whereas MAR will apply from July 3, 2016.
  o Second, Article 4(2) of MAR provides that “[t]he list [published by ESMA] shall not limit the scope of this Regulation.” This means that ESMA’s consolidated list would not be considered as exhaustive; if a trading venue fails to provide a complete list to its Member State regulator, which then passes on that incomplete list to ESMA (which then publishes its consolidated list), a market participant will not be able to rely on the absence of an issuer/instrument from that list and assume that MAR does not apply.

• Investment managers (both EU and non-EU) will thus need to have systems in place to monitor the status of each financial instrument and related issuer, in particular to check whether such financial instrument is admitted to trading on an EU trading venue. As and when the ESMA consolidated list becomes available, investment managers will need to ensure their systems are able to monitor changes to such consolidated list as the list is continually updated.

**Attempted Market Abuse; Amending and Cancelling Orders**

Apart from the expansion of the scope of financial instruments caught in the MAR regime as discussed above, MAR also introduces two changes of note to the insider dealing and market manipulation elements of the EU market abuse regime:

• Attempted insider dealing and market manipulation will itself constitute an offence; and

• The use of inside information by cancelling or amending an order to which the information relates (or attempting to do so), where the order was placed before the person came into possession of the inside information, will also be caught within the insider dealing prohibition.

In addition, in order to address the recent focus by national regulators on algorithmic trading and high frequency trading, MAR provides that certain electronic trading activities (in effect, quote stuffing, layering and
spoofing) that have the effects of giving false or misleading signals to the market or which distort market prices “shall ... be considered as market manipulation.”

**Implications and Action Points to Consider**

- Attempted insider dealing and market manipulation would cover situations where, for example, an order was placed or misleading information was intended to be disseminated, but ultimately did not occur because of a technical fault.

- In relation to cancelling or amending orders, Recital (25) of MAR provides that there should be a rebuttable presumption that “any subsequent change relating that information to orders placed before possession of such information, including the cancellation or amendment of an order, or an attempt to cancel or amend an order constitutes insider dealing.”

- Non-EU investment managers will have to consider whether their local laws might in fact require them to cancel or amend orders upon the receipt of inside information and determine how to address the conflict in non-EU vs EU requirements.

- Finally, on the issue of algorithmic and high frequency trading (both of which terms refer to the equivalent definitions in MiFID II), it would appear that an offence of market manipulation would be committed even where there was no intention on the part of the relevant firm, for example, where a faulty algorithm resulted in quote stuffing or layering. Given the breadth of the definition of algorithmic trading, investment managers may wish to review and update their systems and controls to address the regulatory risk introduced by the express reference to such trading in MAR.

**Market Soundings**

Although wall-crossing is widely practised and there is a general market understanding of the process, MAR for the first time introduces a specific regime for “market soundings.” This is defined in MAR to mean “the communication of information, prior to the announcement of a transaction, in order to gauge the interest of potential investors in a possible transaction ...”

The market sounding regime in MAR provides a safe harbour to the offence of unlawful disclosure of inside information for “disclosing market participants” (DMPs) (e.g., brokers/sell-side firms), provided DMPs adhere to procedural, disclosure and record-keeping requirements set out in ESMA’s technical standards.

Importantly, MAR provides that ESMA is to issue guidelines addressed to “market sounding recipients” (MSRs) (e.g., investment managers/buy-side firms), regarding the factors that MSRs are to take into account when information is disclosed to them as part of a market sounding, the steps that MSRs are to take if inside information has been disclosed to them and the records that MSRs are to maintain in order to demonstrate that they have complied the prohibitions on insider dealing and the unlawful disclosure of inside information.

ESMA is in the process of finalising its market sounding guidelines for MSRs. While some of the proposals for MSRs set out in ESMA’s draft guidelines (the “Draft Guidelines”)

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of the proposals are quite onerous for MSRs. It is possible that the final guidelines might not be published until after July 3, 2016 (i.e., after the date from which MAR applies).

Under the Draft Guidelines, a MSR would be expected, among other things, to:

- Have a designated contact person at the MSR to receive market soundings;
- Assess independently whether it (the MSR) has received inside information from the DMP as a result of the market sounding, and consider whether the MSR agrees with the DMP’s opinion that inside information has or has not been disclosed to the MSR. Where the MSR disagrees with the DMP’s opinion, there are certain situations in which the MSR should inform the DMP, and certain other situations in which the MSR should refrain from informing the DMP. A similar process applies where the DMP informs the MSR that the inside information provided is no longer inside information, i.e. the information has been cleansed;
- In the case of unrecorded meetings or telephone conversations, the MSR is to sign and agree the DMP’s written minutes of the meeting or conversation, or provide their own version to the DMP within five working days after the market sounding;
- Establish internal procedures to manage and control the flow of inside information and ensure internal training of staff on the internal procedures and prohibitions on insider dealing and the unlawful disclosure of inside information;
- Draw up a list of staff possessing information passed during a market sounding;
- Identify all issuers and financial instruments to which the relevant inside information relates; and
- Keep records of all matters relating to the above for a period of five years.

Implications and Action Points to Consider

- The Draft Guidelines are stated to apply to all MSRs; that is, regardless of whether the MSR is a regulated or non-regulated firm, and regardless of location. For example, a U.S. investment manager receiving a market sounding from a U.S. broker in respect of a U.S.NASDAQ-listed issuer whose securities also happen to be admitted to trading on an EU MTF would be an MSR subject to the Draft Guidelines.
- Although ESMA guidelines do not have the force of law, i.e., are not legally binding on the industry, compliance with the guidelines would help an MSR in demonstrating compliance with MAR. Investment managers, regardless of regulatory status and location, will thus need to consider putting in place internal systems and procedures to address the points raised by the Draft Guidelines.
- In relation to the obligation to draw up a list of staff possessing information passed during a market sounding, note that the technical requirements applying to the form and content of “insider lists” for issuers and persons acting on their behalf do not apply to MSRs.
- Given the requirement for the MSR to sign the DMP’s minutes of unrecorded meetings or telephone conversations, or provide the MSR’s own version of the minutes, MSRs may be inclined to have market

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9 Industry associations such as the Managed Funds Association (MFA), Alternative Investment Fund Management Association (AIMA) and The Investment Association (IA) have responded to ESMA’s consultation on the Draft Guidelines, pointing out that some of ESMA’s proposals are overly burdensome on MSRs.
soundings carried out in recorded telephone lines so as to reduce the administrative burden of reviewing
minutes or drafting their own. Such recorded calls would need to be stored for a period of five years.

- Given the explicit reference to staff training on market abuse and the focus of regulators on the proper
handling of inside information, firms may wish to review and update their existing training programmes to
address the new expectations under MAR for MSRs.

**Suspicious Transaction and Order Reports (STOR)**

Under MAR, any person “professionally arranging or executing transactions” in financial instruments will be
required to establish and maintain effective arrangements, systems and procedures to detect and report
suspicious orders and transactions. The STOR obligation extends to OTC derivative transactions. Importantly,
unlike MAD which contains a suspicious transaction reporting regime, MAR extends the regime to include not
only transactions, but orders as well. In addition, MAR captures not only actual orders and transactions, but also
cancellations and modifications of such orders and transactions.

STORs are to be submitted to the relevant regulator “without delay ... once reasonable suspicion of actual or
attempted insider dealing or market manipulation is formed.”

ESMA has stated in its Final Report for the relevant MAR technical standards on STOR that “[f]or the large
majority of entities, the most effective form of surveillance would indeed involve automated systems which
generate alerts.” However, ESMA acknowledges that automated systems should not be mandatory for every
entity, “if another form of surveillance is more appropriate and effective.” Regardless of the system used, there
must be an element of “human analysis” in the detection of orders and transactions.

Finally, records of every report submitted (and the reasons for any order or transaction examined but not
subsequently reported) should be maintained for five years.

**Implications and Action Points to Consider**

- Unlike some of the other obligations under MAR, the STOR obligation appears to apply only to EU firms,
since the report must be made in accordance with the rules of notification in the EU Member State in which
the firm is registered or has its head office.

- ESMA has confirmed in its MAR Q&A that the STOR obligation applies not only to MiFID firms, but also to
AIFMs, UCITs and proprietary traders.

- Firms will need to consider updating their internal policies, procedures, systems and arrangements to
comply with the STOR requirements. In particular, firms will need to consider whether to use automated
surveillance systems. The technical standards provide that, at the regulator’s request, firms will need to

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10 See, for example, TR15/13: Flows of confidential and inside information, Financial Conduct Authority, December 2015.

11 In general, these would be regulated firms; however, ESMA has confirmed in its MAR Q&A that the term would also capture proprietary traders.
Note that, at least at present, certain proprietary trading firms are not required to be regulated under the existing MiFID regime due to the availability
of the MiFID “dealing on own account” exemption; however, this exemption will be significantly narrowed under MiFID II and many proprietary
trading firms will need to be regulated once MiFID II is implemented.

12 Article 16(2) of MAR.

demonstrate the appropriateness of their systems in relation to the scale, size and nature of their business activity, including information on the "level of automation put in place in such systems."

- The technical standards drafted by ESMA allow for a firm to delegate to a group affiliate the monitoring, detection and identification of orders and transactions that could constitute insider dealing or market manipulation. Firms may wish to consider if that is an option for them, but it should be noted that the delegating firm remains fully responsible for discharging the STOR obligation.

**Conclusion**

Investment managers and other market participants, regardless of location, will need to consider their potential obligations under MAR and, in particular, ensure their systems and controls adequately protect against the risk of market abuse. As recent enforcement actions have demonstrated, it is not necessary for market abuse to have actually been committed in order for enforcement action to be taken.\(^ {14} \) Non-EU firms will also need to be familiar with the EU market abuse regime. All firms may wish to consider implementing training programmes for their staff on the new MAR framework.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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\(^ {14} \) In February 2016, the FCA announced that it had fined a UK firm, W H Ireland Limited, £1.2 million for failing to ensure that it had the proper systems and controls in place to prevent market abuse being detected or occurring.